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ECONOMIC RESTRUCTURING IN JAPAN

Summary

During the past six years there has been a sharp rise in the manufacturing sector's share of Japan's economy. The increase paralleled a similar expansion in exports that boosted the nation's trade surplus to record levels. A recent report by the Bank of Japan concluded that an overhaul of the country's economic structure is necessary to reduce the trade surplus to an internationally acceptable level. Although many observers have criticized the pace of reform, steady progress has been made as the private sector has adjusted to the realignment of exchange rates. The strong yen has promoted a shift of productive resources from the manufacturing sector to nonmanufacturing and there has been a surge in direct foreign investment by Japanese firms.

Some business leaders, however, warn that Japan risks repeating the hollowing-out process they believe has taken place in the United States. In fact, manufacturing's share of real gross domestic product has remained roughly constant in the United States during the past 25 years. Economic restructuring in Japan should benefit consumers and improve the quality of life. It may, though, be accompanied by negative side effects, such as increased unemployment and an adverse impact on those regions that depend on export industries.

The Rise of the Service Sector

The service sector plays a major role in the industrial countries. Of the 20 member nations of the Organization for Economic Cooperation and Development listed in Table 1, goods accounted for over 50 percent of gross domestic

product from 1980 to 1984 in only one country -- Turkey. In some of the wealthy nations of North America and Western Europe, its share is only about one-third.

The link between a country's income level and the size of its service sector shown in Table 1 suggests that a service-oriented economy is an inevitable result of economic growth. As income increases, households generally spend a smaller share of their budget on food and consumer durables and develop new tastes for services. And producers emphasize information and services to boost sales and reduce costs. Some analysts, though, view the rising importance of the service sector as an ominous trend that threatens to replace manufacturing employment with menial, low-paying jobs. This bias goes as far back as Adam Smith, who defined services as things that "perish in the very instant of their performance," in contrast to more tangible forms of wealth. The service sector, though, includes many high-skill, technologically advanced enterprises such as telecommunications and data processing.

Still, in the OECD countries the shares of goods and services are equal if the government sector is excluded. Moreover, part of the reported decline in manufacturing is a statistical aberration resulting from increased specialization common to advanced economies. Such activities as data processing and security, which were formerly performed by manufacturers for themselves, are now contracted out to the service sector. According to one study, at least half of all market services are directly linked to the production of goods rather than purchased directly by consumers.*

Japan's service sector accounts for a relatively small share of GDP despite the country's high income level -- largely because the manufacturing sector has grown more rapidly during the past 25 years than in any other OECD country. The distribution of labor also indicates the relative importance of the goods-producing sector, which accounts for just under half of employment in Japan compared to less than one-third in the United States (see Table 2).

The appreciation of the yen since February 1985, though, has had a serious impact on many of Japan's leading industries. The country's five major steel producers, for example, have announced plans to close eight blast furnaces and reduce their workforce by 13 percent by 1990, while Sony Corp. announced plans last month to move one-fourth of its production capacity overseas. The U.S. assembly plants operated by Japanese automotive makers, which will be capable of producing at least 1.7 million cars and trucks a year by 1990 (see JEI Report No. 11A, March 20, 1987), may reduce the size of the domestic industry. And the decline of the textile industry has depressed regions of the country.

Much of the increased foreign competition is coming from the newly industrializing countries of Asia. During the first half of the year, for example, South Korea overtook Japan as the world's largest shipbuilder and it

*Derek Blades, "Goods and Services in OECD Economies," OECD Economic Studies, Spring 1987.

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Table 1: Share of Total Value-Added by Sector in OECD Countries

(1980-84 average)

	Goods					Services					
Country	Total	Primary Products*	Manu-facturing	Con-struction	Other**	Total	Whole-sale, Retail	Transport, Communi-cations	Finance, Real Estate	Other	Non-market Services***
Denmark	34%	6%	19%	6%	2%	66%	14%	8%	16%	5%	24%
United States	35	2	22	4	7	65	17	6	21	8	13
Belgium	36	2	23	6	4	64	n.a.	8	13	n.a.	15
Canada	38	4	19	6	10	62	n.a.	8	13	n.a.	20
Sweden	39	4	24	8	3	61	12	7	13	4	26
Netherlands	39	4	18	7	9	61	13	6	15	12	15
Luxembourg	39	3	27	7	2	61	16	5	12	14	13
France	41	4	27	7	3	59	13	6	18	9	14
New Zealand	41	9	23	5	4	59	21	8	14	3	13
Britain	42	2	24	6	10	58	12	7	18	5	16
Japan	43	3	28	8	3	57	n.a.	6	14	n.a.	10
Austria	44	4	29	8	4	56	17	6	14	3	15
Germany	45	2	33	6	4	55	11	6	n.a.	n.a.	14
Italy	46	6	28	8	4	54	15	6	n.a.	n.a.	14
Finland	46	9	26	8	3	54	11	8	14	4	17
Norway	46	4	15	7	21	54	14	10	12	5	14
Spain	47	9	26	8	4	53	17	7	9	10	10
Portugal	48	10	28	7	3	53	21	5	8	7	12
Greece	48	18	19	7	4	52	13	8	n.a.	n.a.	10
Turkey	53	20	24	4	4	47	16	10	7	6	8
Mean	43	6	24	7	6	57	15	7	14	7	15

*Agriculture, forestry and fishing.
**Includes electricity, gas and water plus mining and quarrying.
***Includes services provided by government and non-profit organizations.

Source: Derek Blades, "Goods and Services in OECD Economies," OECD Economic Studies, Spring 1987.

Table 2: Share of Employment by Sector in OECD Countries

(1980-84 average)

	Goods					Services					
Country	Total	Primary Products*	Manu-facturing	Con-struction	Other**	Total	Whole-Sale, Retail	Transport, Communi-cations	Finance, Real Estate	Other	Non-market Services***
United States	30	4	19	5	2	70	23	4	11	15	17
Australia	35	6	19	7	3	65	20	8	9	23	5
Belgium	35	3	23	7	2	65	19	7	n.a.	n.a.	22
Netherlands	35	6	20	8	1	66	18	7	8	16	17
Sweden	35	5	22	7	1	65	14	7	5	6	33
Denmark	36	8	20	7	1	64	13	7	8	5	31
Britain	37	3	n.a.	n.a.	3	64	n.a.	6	n.a.	n.a.	22
Norway	39	8	21	8	2	61	15	10	5	8	23
France	41	8	23	8	2	59	16	6	7	11	19
Luxembourg	42	5	26	10	1	58	n.a.	7	5	n.a.	13
Finland	46	13	24	8	1	54	14	7	6	4	23
Japan	47	12	24	10	1	53	18	5	4	17	9
Iceland	47	12	24	10	1	53	13	7	6	7	20
Italy	47	12	26	8	1	52	20	6	n.a.	n.a.	17
Germany	48	5	33	8	2	51	16	6	3	8	18
Portugal	54	23	20	10	1	45	12	4	2	15	12
Mean	41	8	23	8	2	59	17	7	6	11	19

*Agriculture, forestry and fishing.
**Includes electricity, gas and water plus mining and quarrying.
***Includes services provided by government and non-profit organizations.

Source: Derek Blades, "Goods and Services in OECD Economies," OECD Economic Studies, Spring 1987.

exported more televisions to the United States than Japan. The Ministry of International Trade and Industry expects imports of steel, largely from Korea and Taiwan, to rise 20 percent this year. In addition, an estimated 80 Japanese companies built manufacturing facilities in the NICs in 1986.

Many analysts fear that these trends will reduce Japanese manufacturing firms to the role of marketing output produced abroad -- a pattern that they see in the United States. According to Sony chairman Akio Morita, "The United States is abandoning its status as an industrial power."

Is the United States Deindustrializing?

The manufacturing sector in this country has been hampered by slow productivity growth, an erosion in technological advantage and a failure to match the product quality provided by foreign producers. These problems, combined with the deterioration in the trade deficit to a record $156.2 billion last year, have created the impression that the United States is deindustrializing. Some observers point to the decline in the manufacturing sector's share of gross national product from over 27 percent in the 1960s to 20.7 percent in the first half of the 1980s as evidence (see Table 3). The decline in manufacturing employment by almost 2 million from its 1979 peak is also viewed as another symptom of the problem.

Table 3: U.S. Gross Domestic Product by Sector

A. Nominal

Period Average	Primary Products*	Construction	Mining	Manufacturing	Services	Government
1960-64	3.8%	4.8%	2.3%	27.9%	50.2%	11.0%
1965-69	3.1	5.0	1.9	27.7	50.3	12.0
1970-74	3.5	5.2	1.9	24.2	52.0	13.2
1975-79	3.2	5.1	2.7	23.1	53.4	12.5
1980-85	2.6	4.6	3.8	20.7	56.2	12.1

B. Real

1960-64	3.7%	9.7%	5.5%	20.9%	45.8%	14.4%
1965-69	2.9	8.5	5.3	22.3	46.9	14.1
1970-74	2.7	6.5	5.2	21.8	50.5	13.3
1975-79	2.5	5.6	4.4	21.8	53.2	12.5
1980-85	2.6	4.7	4.1	21.2	55.5	11.9

Source: Council of Economic Advisers, Economic Report of the President.

In fact, the decline in manufacturing's nominal share is a result of a lower rate of inflation in that sector. While the price of services increased almost five times during the past 26 years, the price of goods (excluding food) rose less than three-fold. In real terms manufacturing's share has remained

constant in the 20 to 22 percent range. Industrial production has performed strongly during the current expansion, increasing 21.3 percent between 1982 and 1986. During the first half of the 1980s, output increased faster in the United States than in any other major industrial country except Japan (see Table 4).

Table 4: GDP and Industrial Production Growth in the Major Industrial Nations

(average annual rate of change)

	1960-73		1973-80		1980-85	
Country	GDP	Industrial Production	GDP	Industrial Production	GDP	Industrial Production
United States	3.8%	5.2%	2.1%	1.8%	2.4%	2.6%
Japan	9.2	11.1	3.6	2.4	3.8	3.9
Germany	4.3	5.0	2.2	1.1	1.3	1.0
France	5.4	5.2	2.8	1.7	1.1	-0.2
Britain	3.1	2.9	0.9	0.1	1.9	1.6

Source: Organization for Economic Cooperation and Development, National Accounts, 1960-85.

Increasing labor productivity has allowed manufacturing employment to decline while output's share of GDP remained constant. The decline does not signal the inability of U.S. producers to compete; instead, it is part of the process by which firms remain internationally competitive. In many ways this trend resembles changes that occurred in agriculture, which employed about one-third of this nation's labor force in 1910. Today, its share is only 3 percent.

Despite the many concerns about industrial competitiveness, it is clear that the U.S. manufacturing sector cannot disappear, given the country's status as the world's biggest debtor nation. The large U.S. external deficit is made possible by the willingness of foreign investors to increase their net lending and investment in the United States. The huge imbalance cannot continue indefinitely. Once foreign investors refuse to continue making large net investments in this country, the U.S. current account, which includes merchandise trade, services (including investment income) and transfers, will have to balance. Moreover, the United States will have to run a trade surplus to service its foreign debt, which could reach as high as $600 billion by the end of the decade. While trade includes services and agricultural products, only trade in manufactured goods is large enough to produce the required improvement in the trade balance.

Although deindustrialization is not a serious threat, efforts to improve U.S. competitiveness are important. If U.S productivity, technology and product quality do not keep pace with foreign producers, this country will have to reduce the price of its manufactured goods on world markets. A substantial deterioration in the terms of trade would cut deeply into the U.S. standard of living.

Trends in Japan

Compared to the United States, manufacturing and construction account for a larger share of GDP in Japan, while the government and service sector shares are smaller (see Table 5). Both countries, though, experienced similar changes in the 1970s; the shares of primary products and construction declined, while manufacturing remained steady in real terms. Industrial production, which grew substantially faster than GDP in Japan's high growth period, fell behind after the first oil shock, as it did in the other major industrial countries.

Table 5: Japan's Gross Domestic Product by Sector

A. Nominal

Period Average	Primary Products*	Con-struction	Mining	Manu-facturing	Services	Govern-ment
1970-74	5.7%	8.3%	0.7%	34.9%	43.4%	7.0%
1975-79	5.0	9.2	0.5	29.9	46.7	8.7
1980-85	3.4	8.4	0.5	29.3	49.9	8.5

B. Real

1970-74	5.6	11.2	0.7	27.0	46.8	8.7
1975-79	4.6	10.4	0.6	27.2	48.4	8.8
1980-85	3.5	8.1	0.5	31.6	48.0	8.3

Source: Economic Planning Agency, Annual Report on National Accounts.

Japan's export-led expansion in the 1980s, though, boosted manufacturing's share of real GDP by 4.4 percentage points. This increase paralleled the rise in exports from 12.3 percent of real GDP in the last half of the 1970s to 15.6 percent during the 1980-85 period. The increase in manufacturing output raised employment in that sector by close to 1 million jobs in contrast to the decline recorded in the United States (see Table 6).

The surge in Japanese exports culminated in a record $94.1 billion current account surplus in FY 1986, the equivalent of 4.5 percent of GNP, and the highest figure recorded by an industrial country in the postwar era. Meanwhile, the United States, which accounts for almost 40 percent of Japan's exports, experienced unprecedented trade deficits. Most economists identify U.S. fiscal policy as the primary cause of recent trade imbalances. Large budget deficits boosted U.S. interest rates, which in turn raised the value of the dollar, leading to a deterioration in the U.S. balance with all regions of the world except the Organization of Petroleum Exporting Countries. The United States accounted for more than half the rise in Japan's trade surplus between 1981 and 1986, while OPEC was responsible for about a quarter of the increase, reflecting the declining price of oil.

Table 6: Changes in Japan's Labor Force

(thousands of workers; percentage change from year-earlier figure)

	Agriculture, Forestry & Fishing	Change	Manu-facturing	Change	Nonmanu-facturing*	Change
1980	5,770	-5.9%	13,670	2.6%	35,920	1.6%
1981	5,570	-3.5	13,850	1.3	36,390	1.3
1982	5,480	-1.6	13,800	-0.4	37,100	2.0
1983	5,310	-3.1	14,060	1.9	37,950	2.3
1984	5,120	-3.6	14,380	2.3	38,170	0.6
1985	5,090	-0.6	14,530	1.0	38,540	1.0
1986	4,950	-2.8	14,440	-0.6	39,140	1.6
1987 January	3,920	0.2	14,300	-2.6	38,930	1.6
February	3,870	0.8	14,220	-2.9	38,940	1.4
March	4,250	-0.7	14,190	-1.9	39,540	2.0
April	5,090	-3.6	14,070	-3.6	40,140	3.0
May	5,450	-3.7	14,100	-1.5	40,210	2.5
June	5,400	-3.2	14,140	-1.0	40,420	2.5

*Includes services, mining, construction, utilities, transportation, communications, wholesale and retail trade, finance, insurance, real estate and government workers.

Source: Management and Coordination Agency

The sharp rise in the yen helped reduce Japan's export volume 1.4 percent in 1986 and bring imports up 13.3 percent. The volume changes will eventually reduce the surplus in dollar terms, which in the April-June 1987 period fell below the year-earlier level for the first time in 18 quarters. A recent study by the Bank of Japan concluded, however, that the impact of the yen's appreciation on trade volumes will begin to fade in the near future, leaving Japan with a sizable nominal surplus. The report warned that "In order to reduce the surplus to an internationally acceptable level in the long run, therefore, an overhaul of Japan's economic structure is required in such a way as to lessen its chronic dependence on external demand."

Economic Restructuring in Japan

The Maekawa Report, a series of recommendations to transform the economy that was drawn up in 1986 by a private commission established by Prime Minister Yasuhiro Nakasone, has received widespread attention both in Japan and abroad. U.S. officials have urged Tokyo to pursue policies, including those recommended in the report, to restructure its economy and reduce its trade surplus. The report has been attacked, though, by some economists in Japan who argue that since the basic cause of the imbalance is U.S. macroeconomic policy, the solution lies in Washington. Moreover, some note that Japan's surplus is not unique; Britain prior to World War I and the United States in the immediate postwar period also ran large external surpluses.

Japan's surplus, though, does pose problems for the world economy. The International Monetary Fund's annual report, released in September, warned that if the U.S. trade deficit and Japanese and German surpluses persist for much longer, there would be "serious implications for growth throughout the world economy." The large Japanese trade imbalance has been accompanied by an unsustainable increase in the U.S. foreign debt. In addition, the success of Japanese exporters has created protectionist pressures in the United States and the European Community that threaten the world trading system. Tokyo's 1987 annual economic white paper warned that Japan risks isolation in the international community if it fails to reduce its trade surplus.

The government has taken measures to promote the restructuring of the economy. The tax reform package passed by the lower house in September revised the preferential tax treatment for saving. In addition, the economic stimulus package announced in May included a substantial increase in public works spending. Other important policies that would promote restructuring include changes in tax and land zoning policies to increase the supply of land and encourage housing construction; a reform of agricultural policies to reduce food prices; and policies to streamline the distribution system, which would also reduce consumer prices.

Despite the steps that have already been taken, many observers have criticized the pace of government efforts to transform the economic structure, giving the impression that restructuring has stalled. In fact, steady progress is taking place as the private sector responds to the high yen. The rise of the yen has affected the composition of demand and the relative profitability of different industries. Profits in the manufacturing sector have been depressed by the decision to pass on only about half of the yen's appreciation in export prices in an effort to maintain market share abroad (see JEI Report No. 12B, March 27, 1987). Meanwhile, the nonmanufacturing sector has not been forced to lower its prices, while benefiting from cheaper inputs, particularly oil, and lower interest rates. The relative profitability of nonmanufacturing has attracted a surge of capital investment in that sector. According to the Japan Development Bank, investment by nonmanufacturing firms will increase 7 percent in FY 1987 following a 12.1 percent rise last year; in the manufacturing sector, though, investment is expected to fall for the second straight year.

The composition of demand also influences the allocation of labor. According to one study, more than half of the jobs created by exports are in manufacturing, while public investment boosts employment in the construction industry (see Table 7). Cost-cutting efforts by firms facing falling export volume reduced the number of manufacturing jobs in June 1987 about 1 percent below a year earlier, while steady growth in domestic demand boosted nonmanufacturing employment by 2.5 percent.

The surge in foreign direct investment is another element of the restructuring process. Overseas investment in manufacturing rose 61.8 percent in FY 1986 to $3.8 billion (see JEI Report No. 25B, July 2, 1987). Some observers expect the share of production overseas by Japanese firms to reach 10 percent by the mid-1990s. Currently, the figure is under 5 percent, while the U.S. share is 23 percent and West Germany's is 19 percent.

Table 7: Jobs Generated by Different Categories of Final Demand

	Personal Consumption	Private Sector Capital Investment	Public Sector Capital Formation	Exports
Agriculture	21.6%	3.0%	1.4%	4.9%
Mining	0.1	0.5	1.2	0.5
Manufacturing	17.1	36.8	23.1	56.7
Construction	0.6	28.3	52.4	0.5
Services	60.6	31.6	21.8	37.4
Total	100.0	100.0	100.0	100.0

Source: Hirohide Tanaka, "Jobs in Danger from the Yen Shock," Economic Eye, March 1987.

The shift of labor and capital away from manufacturing and the move to overseas production should reduce the relative importance of manufacturing in Japan's economy. The growth of other sectors, such as services and construction, should make Japan's economy less export-oriented, while increasing the demand for imports. Manufactured imports increased 34.7 percent in FY 1986 to account for a record 44.1 percent of total imports.

According to the economic white paper, economic restructuring should improve the quality of life in Japan, while reducing the nation's trade surplus. There may be significant adjustment costs, however, such as higher unemployment. MITI estimates that 800,000 jobs will be lost by the turn of the century if manufacturing investment abroad grows at an annual rate of 20 percent. The ongoing business retrenchment has forced employers to rethink such traditional labor practices as lifelong employment and seniority-based wages. Bunpei Otsuki, chairman of the Japan Federation of Employers Association, believes the disruptive effect on labor-management relations is the most serious threat to Japan's economic future.

The government has set 4 percent real growth as the rate necessary to avoid a serious unemployment problem. Even with successful macroeconomic policies, however, there is likely to be a mismatch between the labor skills demanded by the service sector and the skills of workers leaving manufacturing. A recent report by the Economic Planning Agency warned that the unemployment rate is likely to rise above 5 percent unless Japanese workers are more broadly educated and have greater skills.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.